November 2, 2015

The Honorable Paul Ryan
Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Orrin G. Hatch
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Sander M. Levin
Ranking Member
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Ron Wyden
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments on Partnership Tax Audit and Litigation Regime Revisions

Dear Chairmen and Ranking Members:

Enclosed please find comments on Partnership Tax Audit and Litigation Regime Revision (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

cc: Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
John Koskinen, Commissioner, Internal Revenue Service
William J. Wilkins, Chief Counsel, Internal Revenue Service
Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

PARTNERSHIP TAX AUDIT AND LITIGATION REGIME REVISIONS

These comments are submitted on behalf of the Section of Taxation of the American Bar Association (“ABA”) and represent the position of the ABA Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the ABA. These comments accordingly, should not be construed as representing the policy of the ABA. These comments concern proposals for reforming the tax administrative procedures for partnerships. Principal responsibility for preparing and reviewing these Comments was exercised by Timothy Todd, Kevin Johnson, George Hani, Mark Allison, Jennifer Benda, Jeremiah Coder, Tom Cullinan, Michael Desmond, Miri Abrams Forster, Tom Greenway, Clint Massengill, Lee Meyercord, Mary McNulty, Fred Murray, Joshua Odintz, Gregory Rhodes, Lawrence Sannicandro, Kevin Stults, and Shamik Trivedi of the Section’s Administrative Practice Committee (the “Committee”). Helpful comments were provided by Noel P. Brock of the Partnerships & LLCs Committee, particularly with respect to Section III.B.2. below. These Comments were reviewed by Megan L. Brackney, the Section’s Council Director for the Committee, William Kalish, on behalf of the Committee on Government Submissions, and Peter H. Blessing, the Section’s Vice Chair (Government Relations).

Although many of the members of the Section who participated in preparing these comments have clients who may be affected by the federal tax principles addressed herein or who have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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November 2, 2015
EXECUTIVE SUMMARY

We commend Congress for proposing to reform the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") partnership administrative procedures. This is a complex body of law that has created administrative burdens and confusion for both the Internal Revenue Service ("Service") and taxpayers.

We recognize the desire to reform the present partnership administrative regime, but also appreciate that simplification must be balanced against the need for the continued flexibility that the governing tax law permits with respect to the partnership, as an entity in its many forms, including tiered partnership structures and foreign partnerships. We recommend that any modifications to TEFRA should not eliminate benefits to taxpayers who choose to operate businesses and investment activities through partnerships.

Our comments are organized into the following sections:

I. Background: History and Purpose of the TEFRA Partnership Procedures

II. Clarification Needed for Required Actions at Commencement and Completion of TEFRA Audit

III. Congress Should Approach Proposals for Entity-Level Assessments for Large Partnerships Cautiously

IV. Clarification Needed Regarding the Statute of Limitations Period for TEFRA Partnership Refund Claims

V. Clarification Needed to Address Application of Penalties in TEFRA Proceedings

VI. Clarification Needed to Address Jurisdiction, Procedural, and Other Common Issues in TEFRA Litigation Proceedings

VII. Clarification Needed to Address the Difficulties of Applying TEFRA to Tiered Partnerships

Please note that these Comments were prepared prior to introduction of the Bipartisan Budget Act of 2015 (H.R. 1314) (the "Budget Act"). We applaud the provisions in the Budget Act that streamline and simplify the partnership audit rules. We anticipate that the congressional interest in the partnership audit rules will continue and there remains the prospect for some technical corrections or further legislative action in this area. Thus, while the Budget Act addresses or otherwise takes into account some of the comments below, we submit these Comments in anticipation that the Budget Act is just a step in the reform of the partnership audit rules. We expect to review the Budget Act’s enacted changes to the partnership audit rules and supplement these Comments as appropriate. In particular, we are pleased that the Budget Act did not include the imposition of joint and several liability on individual partners for the tax debt, which had been included in prior proposals as discussed below.
I. BACKGROUND: HISTORY AND PURPOSE OF TEFRA PARTNERSHIP PROCEDURES

In 1982, Congress enacted the current framework governing partnership administrative and audit rules in the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”). The TEFRA partnership procedures were enacted, in part, due to the increased use of partnerships in the 1970s and 1980s, including partnerships used to promote syndicated tax shelters marketed to large numbers of individual taxpayers.2

The pre-TEFRA partnership procedures—which required the Service to conduct examinations and control tax returns separately for each partner separately—were impractical, particularly with respect to partnerships that had hundreds or thousands of partners and tiered partnership structures in which the ultimate owners held their interest indirectly through one or more levels of partnerships.3

As discussed in more detail below, the TEFRA partnership procedures were originally intended to create a more efficient means for the Service to conduct examinations of partnerships and their partners, primarily through an entity-level proceeding.4

Under TEFRA, the Service can audit the partnership directly, and any adjustments made as a result of the partnership examination flow through and adjust each partner’s tax return.5 Thus, TEFRA created a unified audit procedure for all partnerships, with exceptions for certain small partnerships that do not raise the same practical audit and litigation considerations.6

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2 See generally Noel P. Brock, Audits of Partnerships, TEFRA and Partnership Noncompliance: Where We Are and Where We Are Going, 93 TAXES 171 (Mar. 2015); see also ARTHUR B. WILLIS ET AL., PARTNERSHIP TAXATION ¶20.01(3) (2015 ed.).

3 In TEFRA parlance, the pass-through partner is commonly referred to as a “tiered partner” and the partnership in which it holds its interest is commonly referred to as the “source partnership”. The partners who own an interest in the source partnership are known as “indirect partners”. For a comprehensive discussion on the applicability of TEFRA to tiered partnership structures, see Mary A. McNulty, Robert D. Probasco, & Lee S. Meyercord, Navigating TEFRA Partnership Audits in Multi-Tiered Entity Structures, 15 BUSINESS ENTITIES 22 (Jan.- Feb. 2013). Congress was aware of the difficulties created by tiered partnership structures. See GAO, LARGE PARTNERSHIPS: WITH GROWING NUMBER OF PARTNERSHIPS IRS NEEDS TO IMPROVE EFFICIENCY, GAO-14-732, at 1-4 (Aug. 18, 2014) (hereinafter “GAO Final Report on Large Partnerships”), available at http://www.gao.gov/assets/670/665886.pdf.


5 See CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶2.07(2)(c) (2015 ed.).

A. Pre-TEFRA Audits

Prior to enactment of TEFRA, the partnership audit regime was dependent on separate examinations initiated at the partner level, and any applicable changes had to be made to each individual partner’s tax return for which an audit had been commenced. Although the Service would use the partnership return as a starting point, any adjustment had to be made separately to each partner’s tax return. This auditing method was inefficient for a variety of reasons, especially as large investment partnerships became more popular.

As partnerships became larger and more complex, the Service often encountered significant difficulties in identifying a partnership’s ultimate partners. With large partnerships having hundreds or thousands of partners, the Service was required to expend significant resources to make adjustments to each separate partner tax return for every partnership-related adjustment.

Adding to the complexity, under pre-TEFRA law, partners were able to take positions on their individual returns inconsistent with the partnership’s reporting position on the same tax items. In addition, a Service determination regarding treatment of a partnership item applied only to that specific partner. This resulted in partners in the same partnership being treated inconsistently with respect to certain partnership items.

Moreover, each partner had a separate statute of limitations period for assessment and refund based on the filing of the partner’s tax return. This meant that the expiration of the applicable statute of limitations depended upon each partner’s unique filing circumstances. There was no procedure by which the Service could obtain a global extension of the limitations period from the partnership to cover all partners. This created considerable difficulties for the Service in controlling the statute of limitations and avoiding the expiration of the statute of limitations for each individual partner.

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7 See STAFF OF THE JOINT COMMITTEE ON TAXATION, supra note 4, at 268.

8 Id.; see also Mortimer M. Caplin & Stuart L. Brown, Partnership Tax Audits and Litigation After TEFRA, 61 TAXES 75, 76 (Feb. 1983) (“Tracing through multiple tiers of pass-through entities to the actual taxpayers was both difficult and time consuming. In some cases, the IRS found it impossible to locate actual taxpayers . . . .”).

9 See STAFF OF THE JOINT COMMITTEE ON TAXATION, supra note 4, at 267.

10 Caplin & Brown, supra note 8.

11 Id.

12 See, e.g., Brock, supra note 2, at 175.

13 Id.
Settlements, too, posed a problem for the Service under the old audit system, as an agreement with one partner was not binding on any other partner.\textsuperscript{14} The same was true of judicial proceedings, as any determination only applied to the particular partner who was a party in the case.\textsuperscript{15} This allowed partners in the same partnership to take different litigation positions, resulting in ad hoc determinations that often produced inconsistent results among similarly situated partners.\textsuperscript{16}

Moreover, the partnership return was strictly informational in nature and did not bind the partners in any way.\textsuperscript{17} This, too, posed a challenge for the Service, as the assessment period began running once a partner’s individual tax return was filed, regardless of when the partnership return (if any) was filed with the Service.\textsuperscript{18}

B. Overview of TEFRA

TEFRA significantly changed and simplified the partnership audit procedures by allowing the Service to conduct an audit and to control the statute of limitations and other procedural aspects of an audit at the entity level. TEFRA bifurcated proceedings into partnership-level and partner-level proceedings. To understand TEFRA, it is best to start with its terms of art.\textsuperscript{19} TEFRA creates the following definitional terms: (1) partnership items, (2) nonpartnership items, (3) affected items, and (4) computational adjustments. The TEFRA audit procedures and treatment of an item depend on the item’s classification under this scheme.

1. Partnership items

A partnership item is defined as “any item required to be taken into account for the partnership’s taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.”\textsuperscript{20} The regulations provide several examples of partnership items, such as the partnership’s aggregate and each partner’s share of “[i]tems of income, gain, loss, deduction, or credit”; “[e]xpenditures by the partnership not deductible in computing its taxable income”; AMT tax preference items; tax-exempt income;

\textsuperscript{14} The Joint Committee on Taxation noted that “settlements were difficult to reach” because the Service had “little incentive to settle with one partner where the issue had to be litigated with respect to other partners.” \textit{Staff of the Joint Committee on Taxation}, supra note 4, at 268.

\textsuperscript{15} \textit{See}, \textit{e.g.}, Brock, \textit{supra} note 2, at 174.

\textsuperscript{16} \textit{See} \textit{Staff of the Joint Committee on Taxation, supra} note 4, at 268.

\textsuperscript{17} \textit{I.R.C.} \textsection 6031.

\textsuperscript{18} \textit{Staff of the Joint Committee on Taxation, supra} note 4, at 268.

\textsuperscript{19} \textit{I.R.C.} \textsection 6231.

\textsuperscript{20} \textit{I.R.C.} \textsection 6231(a)(3).
partnership liabilities; guaranteed payments; and section 754 election adjustments. Partnership items also include “the accounting practices and the legal and factual determinations that underlie the determination of the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc.” Under this rule, for example, “whether partnership property is a capital asset . . . ; whether an item is currently deductible or must be capitalized; whether partnership activities have been engaged in with the intent to make a profit for purposes of section 183 . . .” are all partnership items.

While the statute and regulations provide detailed definitions of partnership items, those definitions are not comprehensive. Consequently, case law has expanded the list of partnership items. For example, courts have held that the timing of a partnership termination under section 708(b)(1)(A) and the release of a partner from a deficit restoration obligation are both partnership items.

Partnership items are examined and adjudicated in a partnership-level administrative proceeding. This proceeding begins when the Service issues a Notice of Beginning of Administrative Proceeding (“NBAP”) and it ends when the Service issues a Final Partnership Administrative Adjustment (“FPAA”). After the partnership-level proceeding, the Service can make computational adjustments arising from application of the results of the partnership-level proceeding to each partner without the need for normal deficiency proceedings. If, however, further factual determinations must be made at the individual partner level in order to apply the results of the partnership-level proceeding, then normal deficiency procedures must be followed.

In a general sense, the partnership is represented by the “tax matters partner” (“TMP”). The TMP’s responsibility is to “keep each partner informed of all administrative and judicial

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22 Treas. Reg. § 301.6231(a)(3)–1(b).
23 Treas. Reg. § 301.6231(a)(3)–1(b).
24 Harbor Cove Marina v. Comm’r, 123 T.C. 64, 80–83 (2004); see also William S. McKee et al., Federal Taxation of Partnerships & Partners ¶10.02 (2015 ed.).
25 Charles W. Bassing III v. United States, 563 F.3d 1280, 1283–84 (Fed. Cir. 2009); see also McKee et al., supra note 24.
26 I.R.C. § 6221.
27 I.R.C. § 6223(a)(1).
28 I.R.C. § 6223(a)(2).
29 I.R.C. § 6230(a)(1).
31 See I.R.C. § 6231(a)(7); see also I.R.C. § 6224(c)(3).
proceedings for the adjustment at the partnership level of partnership items.”

In some situations, the TMP may bind partners to a settlement. The TMP also has the authority to initiate judicial review of the Service’s determination of partnership items.

2. Nonpartnership items

A nonpartnership item is any item “which is (or is treated as) not a partnership item.” Nonpartnership items are assessed using the traditional deficiency procedures.

3. Affected items

An “affected item” is “any item to the extent such item is affected by a partnership item.” Examples of affected items include the partner’s basis in his or her partnership interest and section 465 at-risk limitations. Penalties and additions to tax may also be affected items. Affected items are not subject to the TEFRA partnership-level proceedings, in effect causing normal deficiency procedures to be used for affected items at the partner level.

Because affected items are, by definition, contingent upon partnership items, any partner-level litigation involving them must wait “until the resolution of the partnership proceeding.” In addition, the Tax Court has held that the Service may challenge an affected item if it accepts the partnership’s return as filed, although in that context it is bound by the partnership’s reporting.

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32 I.R.C. § 6223(g).

33 I.R.C. § 6224(c)(3).

34 I.R.C. § 6226. Other partners may initiate the judicial proceeding if the TMP does not. See I.R.C. § 6224(c)(3).

35 I.R.C. § 6231(a)(4).


37 I.R.C. § 6231(a)(5).

38 Treas. Reg. § 301.6231(a)(5)-1(b), (c).

39 Treas. Reg. § 301.6231(a)(5)-1(e). Although penalties are generally an affected item, § 6221 provides that the threshold application of penalties shall be determined in the partnership-level TEFRA proceedings.

40 See I.R.C. § 6221.


42 See, e.g., McKee et al., supra note 24, at ¶10.02[5]; see Roberts v. Comm’r, 94 T.C. 853 (1990).
4. Computational adjustments

A computational adjustment is “the change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item.”\(^{43}\) Computational adjustments, so long as they do not require further factual determinations at the partner level (in which case they are “factual affected items” subject to deficiency proceedings), can be assessed against a partner without issuing a notice of deficiency.\(^ {44}\)

C. Application of TEFRA

The TEFRA rules provide for simplified partnership examination and litigation processes compared to the pre-TEFRA processes, but there are a number of areas that remain uncertain, confusing, and unnecessarily complex to both taxpayers and the government. We review some of those areas and provide suggestions to improve the partnership audit and litigation procedures.

II. CLARIFICATION NEEDED FOR REQUIRED ACTIONS AT COMMENCEMENT AND COMPLETION OF TEFRA AUDIT

We respectfully suggest that any legislative changes to the partnership audit procedures clarify certain required actions on the part of the Service when a TEFRA audit begins and ends so that all effected partners are adequately informed and the result of the audit can be implemented in the least burdensome manner possible for all partners.

A. Notification Procedures at the Commencement and Conclusion of all Partnership Audits

The Service has a computerized control system known as the Partnership Control System (“PCS”), which links partner tax returns with the TEFRA partnership return being examined. The PCS is used to automatically issue notices required under the TEFRA partnership provisions including (1) the NBAP that the Service issues upon initiating a TEFRA partnership audit, and (2) the FPAA, issued at the end of a TEFRA partnership audit. The PCS system only tracks information from the Forms K-1 of the partnership under audit and, unless an indirect partner specifically identifies itself to the Service under the notice procedures, it will not receive an NBAP or FPAA.

The Service has taken the position that it is not required to issue an NBAP or an FPAA if it examines a TEFRA partnership return but ultimately concludes that it will not make any adjustments to that return.\(^ {45}\) The Service apparently takes this view based on the timing requirement in section 6223(d)(1), which provides that the Service “shall mail” the NBAP to each partner entitled to such notice “not later than the 120th day” before the FPAA is mailed to the TMP. Under the Service’s view, if there is no FPAA then there is no need for an NBAP.

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\(^{43}\) I.R.C. § 6231(a)(6).

\(^{44}\) I.R.C. § 6230(a).

We believe that the Service’s view is contrary to the spirit and intention of section 6223(a), which provides that the Service must provide partners notice at the start and conclusion of any TEFRA partnership administrative proceedings. We recommend that the Service issue such notices even in situations in which the Service determines that no adjustments are warranted as a result of the audit, as doing so will give notice to taxpayers that an adjustment may be forthcoming. Moreover, such notice is, in our opinion, a best practice for equitable tax administration. Accordingly, we suggest that section 6223(d)(1) be revised to require the issuance of the NBAP no later than 3 days after the beginning of the administrative proceeding at the partnership level and no later than 120 before the FPAA is mailed to the TMP. The 3-day rule will ensure all partners entitled to notice receive such notice regardless of whether an FPAA is ultimately issued. Maintaining the 120-day rule ensures that the partners entitled to notice receive such notice sufficiently before any final decisions are made in the audit.

B. Examinations Resulting in Refunds

Section 6230(d)(5) provides that “[i]n the case of any overpayment by a partner which is attributable to a partnership item (or an affected item) and which may be refunded under this subchapter, to the extent practicable the credit or refund of such overpayment shall be allowed or made without any requirement that the partner file a claim therefor.” Similarly, Internal Revenue Manual ("IRM") § 4.31.4.2.5(5) provides that the Service may unilaterally process and issue refunds when a partnership item of a TEFRA entity results in a refund to a partner. In the alternative, the partner may file an administrative adjustment request ("AAR"), which must be filed within the appropriate statute of limitations period. In the event that the Service fails to process and issue the refund, the individual partner can still file a claim for refund.46

In practice, after the conclusion of a TEFRA partnership audit that results in adjustments causing refunds to the partners, the Service generally requires the partnership to issue amended K-1s to the partners and the partners to file amended tax returns in order to obtain the refunds. The Service essentially shifts the burden to the partnership and partners to request the refunds through amended returns.

We believe that this process is unduly burdensome on partnerships and partners (both direct and indirect) when a refund is due as a result of the partnership audit. The Service issues refunds as a matter of course if an audit of an individual, corporation, or other taxpaying party results in an overpayment of tax, and we suggest that the Service should similarly issue refunds when its examination of a partnership creates overpayments for the partners. This can also create a trap for the unwary or less sophisticated partner, who is aware that an entity-level adjustment will result in a refund but may be unaware of the technical requirements that may be needed to secure that refund under section 6230(c)(1)(B).

It is our understanding that the Service takes this approach because of budget and personnel shortfalls. While we understand that automatically issuing refunds to partners may create additional work for the Service, we believe that the Service should be able to obtain the necessary technology to efficiently process refunds in TEFRA partnership audits. Simply

46 I.R.C. § 6230(c)(1)(B),
eliminating the phrase “to the extent practicable” from section 6230(d)(5) will signal to the Service that the normal practice should be the issuance of the credit or refund without the need for prompting such action by the individual partner. The remedy for a taxpayer in the case of the Service failing to so act will still be that the individual partner can file a claim for refund (as provided in section 6230(c)(1)(B)), but the expectation should be that this will be the exception rather than the rule.

C. Clarification on the timing for computation adjustments, assessments, and refunds after a settlement

The timing of computational adjustments, assessments, and refunds after the conclusion of an audit is unclear. Pursuant to sections 6229(d) and 6229(f), TEFRA provides at least a one-year period after conclusion of the partnership-level proceedings in which the Service can take the necessary action to assess the tax attributable to partnership item adjustments. There are two ways that the partnership item adjustments become final as to a partner: (1) by a final determination at the conclusion of the partnership proceeding or (2) by settlement with a partner.

The computational adjustments resulting from an FPAA occur when no section 6226 petition is filed contesting the FPAA or, if contested, when the decision of the court becomes final. In either case, the partnership items do not convert to nonpartnership items, and the resulting computational adjustments must be made within the partnership period of limitations, as suspended by section 6229(d).

If the Service and a partner enter into a settlement agreement before the FPAA becomes final, either at the administrative or litigation stage of the partnership proceeding, that partner’s partnership items convert to nonpartnership items. The period for assessing tax on these converted items is governed, at least in part, by section 6229(f)(1), which provides that the statute of limitations for assessing converted items shall not expire before one year after the conversion date.

The application of section 6229(f)(1) to converted item computational adjustments is unclear in many respects. For instance, the “shall not expire” language in section 6229(f)(1) raises the question whether the Service has, for purposes of assessment, the longer of the section 6229(f) one-year period, or the time remaining on the section 6501 statute for the partner’s nonpartnership items. Questions also arise as to how to compute the unexpired portion of the section 6229(f) one-year period, and when (and if) the expired portion of the section 6229(f) one-year period can be tacked on to a period for which the partnership period of limitation was suspended by section 6229(d). The tacking regime creates a lack of uniformity in determining when assessments can be made (i.e., instead of the assessment being made within a one-year period, it can be made within a one-year period plus a random number of days that must be determined on a case-by-case basis).

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47 I.R.C. § 6231(b)(1)(C).

The deadline for filing of claims and issuance of refunds resulting from changes to partnership items is also unclear. Section 6230(c)(1)(B) provides that when the Service fails to issue refunds resulting from settlements and FPAAs, the partner may file a claim within two years after the settlement is entered into or within two years after the period under section 6226 for contesting an FPA has expired. Section 6230(d)(1) further provides that refunds may not be issued after the period of limitation under section 6229, as discussed above, has expired. The incorporation of section 6229 (and its ambiguities relating to the timeliness of assessments applicable to settlements) into section 6230(d) creates ambiguities regarding the timeliness of refund claims under section 6230(d).

Clarification of these issues will help create certainty for both the Service and taxpayers, as well as uniformity in tax administration.

III. CONGRESS SHOULD APPROACH PROPOSALS FOR ENTITY-LEVEL ASSESSMENTS FOR LARGE PARTNERSHIPS CAUTIOUSLY

The Service currently struggles to close audits and to apply the resulting adjustments to the ultimate partners, especially in large partnerships and multi-tiered partnership structures. Several proposals have been made to simplify the process of effectuating the results of an audit of a large partnership by allowing the Service to make an entity-level tax assessment for which the audited partnership would be liable. Specific proposals, discussed below, were introduced in 2014 as the Partnership Auditing Fairness Act (S. 3018) and the Tax Reform Act of 2014 (H.R. 1) and then again in 2015 as the Partnership Audit Simplification Act (H.R. 2821).

These entity-level assessment approaches, however, take away a significant tax benefit from forming a partnership—namely being a flow-through entity not subject to tax. We suggest that this hallmark partnership tax benefit should not be taken away lightly. We suggest that a less draconian approach would be to expand the application of the current electing large partnership (“ELP”) rules. Under these proposals, if the Service passes adjustments through to the direct partners of the partnership under audit and a direct partner is a flow-through entity, that partner would be treated as a mandatory ELP and subject to an entity-level assessment. This approach would address the complex computational problems present in multi-tiered partnerships. In addition, we suggest that Congress codify the option now present only in the Internal Revenue Manual and allow a partnership to enter into a closing agreement with the Service by which the partnership pays the tax on the net adjustments at the highest marginal rate. Such an approach is an optional entity-level assessment alternative and recognizes that partnerships sometimes prefer an entity assessment.

Separately, much of the complexity related to TEFRA audits could be alleviated with improved technology for the Service. With modern technology and computer programs, businesses in the private sector are able to make complex calculations and computations across a number of entities. While we acknowledge that budgetary constraints are a reality for both the Service and Congress, we respectfully suggest that additional Service funding targeted to

technology should be able to resolve this issue of flowing through partnership adjustments resulting from audits of large partnerships and multi-tiered partnership structures. Finding a technological solution to this issue would allow taxpayers to efficiently structure their business and investment activities through partnerships while retaining the intended hallmark tax benefit of a partnership not being subject to an entity-level tax.

A. Current Assessment Procedures under TEFRA

Under the current TEFRA rules, audit adjustments must be passed through to the ultimate partners for the impacted tax year, and the tax is assessed against and paid by the partners individually, rather than by the partnership. As described in Part II, above, to pass the audit adjustments through to the taxable partners, the Service must link the partnership return (Form 1065) to the partner returns (Form 1040) on its PCS system. This process is largely manual and paper driven, rather than electronic. In large partnerships with multiple tiers and many partners, linking partnership and partner returns is an extremely time consuming and expensive process. For example, in 2011, there were more than 10,000 partnerships with more than 100 partners, of which 78% had six or more tiers of partners.

Under an alternate system for certain ELPs, any adjustment to partnership income is generally treated as an item of income of the partnership in the tax year in which the adjustment takes effect. An electing large partnership is generally any partnership with at least 100 partners in the preceding tax year and which elects to have the rules of Part IV, subchapter K of the Code apply. The adjustment generally takes effect in the year in which the adjustment is made, the year when the adjustment is allowed by the Secretary (if made pursuant to an administrative adjustment request under section 6251), or the year when the decision of a court becomes final (if made pursuant to a decision of a court). Alternatively, and in lieu of passing the adjustment through to its partners, the ELP may elect to pay an imputed underpayment of tax.

The difficulty of linking partner returns with partnership returns in large partnership audits may explain, in part, why so few large partnerships are being audited as compared to large corporations. In 2012, the Service audited less than 0.8% of large partnerships compared to

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50 GAO Final Report on Large Partnerships, supra note 3, at 29.

51 See Treasury and IRS, Widely Held Partnerships: Compliance and Administration Issues – A Report to Congress (Washington, D.C., Mar. 30, 1990) (applying TEFRA to large partnership audits is an intensive and inefficient use of limited Service resources, requiring the Service to spend more time on administrative tasks).

52 GAO Final Report on Large Partnerships, supra note 3, at 13, 16.

53 I.R.C. § 6242(a)(1).

54 I.R.C. § 775(a).

55 I.R.C. § 6242(d)(2).

56 I.R.C. § 6242(a)(2).
27.1% of large corporations.\textsuperscript{57} To eliminate the time and expense of passing audit adjustments through to the taxable partners, there have been several proposals discussed below, some of which would shift the payment of tax from the partners to the partnership under audit (the “source partnership”) or to certain pass-through partners in an entity-level assessment.\textsuperscript{58}

B. Entity-Level Assessment Proposals

As noted above, various approaches have been proposed recently to address the complexities of TEFRA audits and provide a more simplified approach to audits of large partnerships. Some proposals would repeal TEFRA entirely and provide for mandatory partnership-level assessments. Other proposals would expand the universe of partnerships subject to the ELP regime by making that regime mandatory for certain partnerships. As noted below, any new partnership-level assessment approach raises serious concerns. Expansion of the ELP to include certain partnerships may be a less draconian alternative that still eliminates many of the complexities of auditing large partnerships.

1. Levin and Camp Proposals

In 2014, two now-retired Members of Congress, Democratic Senator Carl Levin and Republican Congressman, Dave Camp, the former Chair of the House Ways and Means Committee, separately introduced nearly identical legislation that would repeal TEFRA and the voluntary procedures applicable to electing large partnerships (“ELPs”), and would require certain large partnerships to pay the tax due for any imputed underpayment.\textsuperscript{59} These procedures would apply to all partnerships except for partnerships that have 100 or fewer partners (none of which are pass-through entities) and make a valid election out of the entity-level procedures.\textsuperscript{60} In these proposals, the partnership would act through a designated representative who could be a partner or other person chosen by the partnership, such as a CFO or VP of Tax. Other than situations in which a partner acts as the designated representative, partners would not be able to participate in, or contest the results of, a partnership audit.

Under the Levin and Camp proposals, if a partnership audit results in an underpayment, the underpayment is imputed to the year during which the adjustment is finally determined (the adjustment year), and not the year under audit. Any imputed underpayment must be paid by the adjustment year return due date determined without extensions. The tax would be calculated at

\textsuperscript{57} GAO Final Report on Large Partnerships, \textit{supra} note 3, at 20.

\textsuperscript{58} Under current law, electing large partnerships may pay tax at the entity level rather than passing the adjustments through to partners. However, very few large partnerships elect to be treated as an electing large partnership. In 2011, only 15 partnerships with 100 or more direct partners and $100 million or more in assets elected to be treated as an electing large partnership. GAO Final Report on Large Partnerships, \textit{supra} note 3, at 31.


\textsuperscript{60} Partnership Auditing Fairness Act, S. 3018, 113th Cong. (2014); Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014).
the highest tax rate in effect, but the partnership would have 180 days after the notice of proposed partnership adjustment to establish that the tax should be calculated at a lower rate based on the completed amended returns of each partner for the audit year. The partnership and all adjustment-year partners would be jointly and severally liable for the tax. If the audit results in a taxpayer-favorable adjustment, there would be no refund. Instead, that taxpayer-favorable adjustment would reduce the non-separately stated income or increase the non-separately stated loss reported on the partnership return in the adjustment year.

Similar to the Levin and Camp proposals, a report by the Government Accountability Office issued last year recommended that partnerships with more than a certain number of direct and indirect partners be required to pay any tax resulting from an audit adjustment at the partnership level.61

2. Renacci Proposal

Legislation proposed in June 2015, H.R. 2821, the Partnership Audit Simplification Act of 2015 (the “Proposal”), raises significant concerns with respect to the proposed imposition of joint and several liability on partners and the lack of a practically usable exception for small partnerships from the entity-level proceeding rules.

a. Joint and Several Liability

As drafted, the Proposal would impose joint and several liability on each of (1) the partnership under audit, (2) all direct and indirect partners during the year in which the Service’s income tax adjustment is imposed (an “Adjustment Year Partner”) and (3) all direct and indirect partners of the partnership during the year that is the subject of the Service’s examination and adjustment (a “Reviewed Year Partner”).62 The joint and several liability rule included in the Proposal operates to shift the collection of federal income tax due as a result of an examination, not only to the entity (i.e., the partnership), but also to each Reviewed Year Partner and each Adjustment Year Partner (regardless of whether they were owners during the “reviewed year”). Thus, under the Proposal, a partner’s potential obligation for the underpayment is not limited to the partner’s current allocation of expenses or to the partner’s total capital contributed to the venture, but potentially for the entire amount of the tax assessed against the partnership for any open year.

We note that a partner’s potential liability under the Proposal would exceed that of a shareholder in a corporation. We also recognize that most partnerships today operate in a limited liability entity (e.g., a limited liability company, limited partnership, limited liability partnership, etc.). The joint and several liability rule of the Proposal would, to the extent a partner’s liability under the Proposal exceeded the partner’s total capital contribution to the partnership, nullify state limited liability laws for those partnerships operating in limited liability form.


62 Very briefly, under the Proposal, a “reviewed year” means the partnership taxable year to which the item being adjusted relates and an “adjustment year” means the partnership taxable year in which either (a) a final decision of a court in a proceeding brought under section 6234 becomes final, (b) an administrative adjustment request is made under section 6226, or (c) the notice of the final partnership adjustment is mailed under section 6231.
While we understand the government’s need to ensure payment of a partnership’s tax liability, we believe there are other, less onerous, methods to achieve that result. One possibility would be a withholding regime similar to section 1446.\(^{63}\) Under section 1446, partnerships are required to withhold not only on partnership distributions to partners, but also on allocations of income to partners (regardless of whether a distribution is ever made).\(^{64}\) Thus, under such a withholding regime, the partnership would be required to withhold from those partners to which the partnership allocated the income (the reviewed year partners) and in the year in which the income arose (the reviewed year). The amount so withheld would be immediately remitted to the government in the year withheld. If the partnership failed to withhold, or if the partnership withheld but failed to remit, then the partnership would be subject to withholding liability.\(^{65}\)

b. Applicability to “Small Partnerships”

As drafted, the Proposal’s entity-level audit rules apply to all partnerships, but certain qualifying partnerships are permitted to opt out of those rules. Generally, partnerships may elect out if they have 100 or fewer partners on the last day of the tax year and each partner is either an individual, a C corporation (other than a REIT or RIC), a foreign entity that would be treated as a C corporation if it were domestic, or an estate of a deceased partner. Because of the restrictions on permitted partners, many small partnerships would not be permitted to elect out.

All prior proposals for entity-level audits over the last two years excluded from their application partnerships with less than a certain number of partners. We believe the burden on small partnerships (small businesses) and their advisers would be significant and unprecedented under the current proposal. Many small partnerships and their advisers will not know about the right to opt out of the application of entity-level audit rules. Moreover, many partners in small partnerships will not appreciate that by becoming a partner in the partnership they have given up many rights regarding control of the audit – a rule that is very different from the rule today. Under subchapter K, there are numerous instances in which partners’ rights are economically conflicted and partners would be incentivized to take contrary positions when the partnership is under audit.\(^{66}\)

\(^{63}\) Our concerns over a joint and several liability rule also extends to other proposals that seek to impose joint and several liability. See, e.g., Section III.B.1 supra.

\(^{64}\) See I.R.C. § 1446(b)(1) (the amount to be withheld from foreign partners is equal to “the applicable percentage of the effectively connected taxable income of the partnership which is allocable under section 704(b) to foreign partners”) Emphasis added. See also Treas. Reg. § 1.1446-2(b)(1) (calculation of the amount to be withheld is based on the foreign partner’s distributive share of partnership gross income and gain for the partnership’s tax year that is effectively connected and properly allocable to the partner under section 704(b)). Since no cash is actually distributed when a partnership withholds on an allocation of a partner’s distributive share, most partnership agreements include a provision treating any amount required to be withheld and remitted on an allocation as if the partnership distributed cash to the partner and the partner paid the cash to the government. In fact, the Regulations specify the same treatment for withheld amounts. See Treas. Reg. § 1.1446-3(d)(v).

\(^{65}\) See Treas. Reg. § 1.1446-3(e) (“Liability of partnership for failure to withhold”).

\(^{66}\) See, e.g., I.R.C. §§ 704(c), 736 and 751.
An alternative that would not overly burden small partnerships and their advisers would be to set the default rule for small partnerships, however defined, so that the status quo remains unchanged unless the partners of the small partnership elect to have the entity-level audit rules apply. One possible definition of a small partnership for this purpose would be a partnership with no more than 25 direct partners (whether tax-paying or passthrough), no more than 100 indirect tax-paying partners, no more than three tiers of ownership in the structure, and/or no more than a certain dollar amount of revenues or assets. Once a partnership failed to meet one or more requirements for exemption from the entity-level audit rules, then it would automatically be subject to the entity-level audit rules contained in the Proposal for all future tax years – even if subsequent events caused the partnership to satisfy all requirements in later years.

3. Mandatory ELP Treatment

Other proposals would expand the universe of partnerships treated as ELPs by requiring certain partnerships to be treated as ELPs. For example, President Obama’s fiscal year 2015 budget proposal would require all partnerships with 1,000 or more direct and indirect partners to be treated as ELPs, which would generally cause any audit adjustments to be taken into account by the partnership in the year of adjustment. The Service’s Chief Counsel, William J. Wilkins, has suggested a similar approach. Under his approach, if the Service passes adjustments through to the direct partners of the partnership under audit and a direct partner is a flow-through entity, that partner would be treated as a mandatory ELP and subject to an entity-level assessment. This proposal would avoid the complexity associated with passing audit adjustments through multiple tiers to the “hundreds of non-pass-through partners at the end of each thread.” In public remarks, Chief Counsel Wilkins has stated that, in any partnership audit reform, “the critical ingredients are centralizing audit and assessment processes so that the

67 See Department of Treasury, General Explanations of the Administration’s Fiscal Year 2015 Revenue Proposals, at 217-19 (Mar. 2014), available at http://www.treasury.gov/resource-center/tax-policy/documents/general-explanations-fy2015.pdf. President Obama’s fiscal year 2016 budget proposal would repeal the ELP provisions and enact new audit rules for any partnership that has 100 or more direct partners, or that has at least one partner that is a passthrough partner. President Obama’s 2016 proposal follows the Levin and Camp proposals discussed above, except that the adjustment would flow through to those partnerships that held partnership interests in the year to which the adjustment relates, not those partners who hold interests in the year the audit takes place and the adjustments are determined. The additional tax due as a result of the adjustments would be assessed and collected from the direct partners and not from the partnership, except that passthrough partners would be required to pay the tax on behalf of their partners. This approach is similar to that suggested by Chief Counsel Wilkins. See Joint Committee of Tax’n, Description of Certain Revenue Provisions Contained in the President’s Fiscal Year 2016 Budget Proposal (Sept. 2015); available at http://www.jct.gov/publications.html?func=startdown&id=4841.


69 Id.

Service interactions can be confined to dealing with a representative of the operating partnership and, possibly, its first tier of owners, but no tiers beyond the first tier.\textsuperscript{71}

4. Summary and Recommendations

The common theme among the entity-level assessment approaches discussed above is a shift in the payment of tax from those persons who were partners for the year under audit and received the tax benefit from the tax item at issue, to the partnership (and effectively its current partners) or a first-tier pass-through partner. Chief Counsel Wilkins’s proposal differs in that the entity-level assessment would apply to those direct partners that are pass-through entities, rather than the partnership under audit. We believe this would help limit the draconian nature of the entity-level assessment to those situations that cause the most serious administrative complexities in effectuating the results of a partnership audit.

In addition, we recommend that Congress codify the option now present only in the Internal Revenue Manual that allows a partnership to enter into a closing agreement with the Service under which the partnership pays the tax on the net adjustments at the highest marginal rate.\textsuperscript{72} The payment would be calculated by reference to the ultimate partners’ estimated liability, applying the highest individual rate to the partnership adjustment. Entity-level closing agreements are a practical solution often desired by large partnerships with multiple tiers to close an audit, particularly when the cost and burden of calculating the tax due from the ultimate partners outweighs the amount at issue.

C. Additional Service Funding Needed

We respectfully request that Congress consider allocating specific funding to the Service to allow the Service to create an automated computer program that would efficiently link partner returns to partnerships under audit and that would flow any partnership adjustments through to the ultimate tax-paying owners of the partnership in the proper tax year. Additionally, the funding should specify that the Service create specialized examination teams that will audit partnership returns throughout the United States.\textsuperscript{73} We believe computerization and specialization are necessary prerequisites for the Service to effectively and efficiently audit partnership returns. We believe this approach would preserve the accounting period rule\textsuperscript{74} and protect the government against possible taxpayer abuse.\textsuperscript{75}

\textsuperscript{71} Id.

\textsuperscript{72} IRM § 8.19.10.4.8.6 (Partnership Pays Assessment, Oct. 30, 2013).

\textsuperscript{73} Service focus group participants stated that “they had limited knowledge of the technical issues for partnerships and they may only work on a partnership audit once very few years.” GAO Final Report, supra note 3, at 32.

\textsuperscript{74} I.R.C. § 441.

\textsuperscript{75} See Brock, supra note 2, at 194 (recommending consideration be given to the possibility of taxpayer abuse in situations where, for example, a partner has an expiring tax attribute(s) or where there are transfers of
IV. CLARIFICATION NEEDED REGARDING THE STATUTE OF LIMITATIONS PERIOD FOR TEFRA PARTNERSHIP REFUND CLAIMS

In several notable areas of TEFRA, the statute of limitations provisions for Administrative Adjustment Requests (“AARs”)—the partnership equivalent of claims for refunds—operate in a manner that is materially different than the parallel provisions applicable to non-TEFRA taxpayers. In comparing these provisions, we see no policy or other reason for any distinction in the treatment between TEFRA taxpayers and non-TEFRA taxpayers in this regard, and the inconsistency only appears to serve as a potential, if not actual, trap for the unwary. Such traps are antithetical to equitable tax administration.

Under section 6532, taxpayers may not bring suit with respect to a refund claim before six months after the filing of the claim or later than two years from the date of the notice of disallowance of such claim by the Service. The parallel provisions in TEFRA under section 6228(a)(2)(A) require that a suit with respect to an AAR that is not allowed in full be filed no earlier than six months after the filing of the AAR and no later than two years after the filing of the AAR. Once the two-year period has passed, no suit can be filed with respect to the AAR, regardless of whether or not the Service has taken any action on it, unless the two-year period has been extended by agreement or the Service has issued an NBAP.\(^{76}\)

The difference between the non-TEFRA and TEFRA provisions lies in the trigger for the two-year statute of limitations—in the case of section 6532, it is based on the formal Service notice of disallowance, while under section 6228 it is based on the filing of the AAR. This difference is important because the notice of disallowance serves as an official determination to the taxpayer concerning its refund claim position and provides a prompt to contest that disallowance in court. Without such clear notice, as in the case of AARs under TEFRA, the taxpayer may easily lose track of the need to file suit while it waits for the Service to take action. As a result, taxpayers in TEFRA cases are unnecessarily exposed to the risk of missing an opportunity to file suit with respect to an AAR. Thus, we recommend that section 6228(a)(2)(A) be amended to require a taxpayer to file suit within two years of the issuance of a notice of disallowance of the AAR, consistent with the requirements of section 6532.

Moreover, section 6511(a), the provision governing the general statute of limitations for credit or refund claims, allows a taxpayer to file a refund claim within the later of three years from the filing of the tax return or within two years of the payment of the tax. In contrast, the TEFRA provisions allow an AAR to be filed only within three years of the filing of the partnership return. While the difference in treatment may have logic for AARs filed on behalf of partnership interests between taxable and tax-exempt (or tax indifferent) partners before any entity-level assessment of partnership tax be allowed).

\(^{76}\) I.R.C. § 6228(a)(2)(D).

\(^{77}\) If the IRS has issued an NBAP but does not timely issue an FPAA, the period of limitations for filing suit on the AAR does not expire before the date that is six months after the expiration of the period of limitations for issuing the FPAA. I.R.C. § 6228(a)(2)(C). If the IRS timely issues an FPAA, the taxpayer include any adjustments in the AAR in the petition for judicial review of the FPAA. I.R.C. §§ 6226(f), 6228(a)(2)(B), 6228(a)(3)(A).
a partnership because partnerships do not pay tax, the result is a potentially truncated window for AARs with respect to partnership items. In addition, any partner may file an AAR, and allowing such an AAR to be filed within two years from when the partner paid the tax relating to the partnership item is logical and appropriate. It also makes the statutes of limitation on AARs consistent with the statute of limitations for refund claims outside of TEFRA.

Partnership returns often are prepared and filed before the partner-level returns are filed, because partners must await the Schedule K-1s from the partnership before they can file their own returns. As a result, partners of many partnerships are compelled to file their income tax returns based on an extended due date. Thus, the three-year window for filing an AAR by a partner likely will close less than three years after the filing date of the partner’s return. To remedy this situation, we recommend that the statute of limitations for filing an AAR be amended to allow an AAR to be filed three years from the later of the filing of the partnership return or the partner-level return. This would result in consistent treatment between the statute of limitations for the assessment of partnership items and the filing of AARs. In the case of the assessment of partnership items, it is now well accepted that the assessments may occur within three years of the later of the filing of the partnership return or the partner-level return.78

V. CLARIFICATION NEEDED TO ADDRESS APPLICATION OF PENALTIES IN TEFRA PROCEEDINGS

Penalties related to TEFRA partnerships present jurisdictional and efficiency concerns for which courts have spent the better part of a decade attempting to resolve.79 The current law allows only partnership items and certain threshold penalty determinations for TEFRA partnerships to be determined in a TEFRA partnership-level proceeding, which in some cases necessitates a separate partner-level proceeding for items that require partner-level determinations.

When a penalty is applied at the partnership-level, a partner who has partner-specific defenses cannot raise them in that proceeding, but must raise the defenses in a later refund action. This becomes problematic when the partnership has only a few partners or the penalty depends on partner-level factual determinations. In these cases, current law decreases administrative efficiency, increases litigation costs, and denies taxpayers a prepayment forum with respect to certain penalties.

A. Penalties in TEFRA Proceedings

Under current law, in partnership-level proceedings, the Tax Court has jurisdiction to determine certain penalties. Originally, penalties attributed to partnership items were considered affected items and thus could be asserted against the partner only in deficiency proceedings after the completion of the partnership-level proceeding. The Taxpayer Relief Act of 1997 (“TRA


79 The Tax Court in Tigers Eye Trading, LLC v. Commissioner dedicated several pages at the end of its opinion in an “Afterward” noting the abundance of problems with penalties in TEFRA cases and asking for solutions. 97 T.C.M. (CCH) 1622 at 23-27 (2009).
97") implemented new procedures that provided for the determination of penalties in a partnership-level proceeding. Specifically, Congress allowed for the determination of “the applicability of any penalty . . . which related to an adjustment to a partnership item” and expanded the scope of jurisdiction in partnership-level judicial proceedings to make threshold determinations as to the applicability of such penalties. Congress also amended section 6230(c) to provide that, although the determination of the applicability of the penalties is conclusive in later proceedings, the partner is allowed to assert his or her partner-level defenses in a later refund action.

Typically, a taxpayer can avoid the imposition of accuracy-related penalties if the taxpayer can show that there was reasonable cause for the underpayment and the taxpayer acted in good faith with respect to that portion of the underpayment. In the partnership-level proceeding, the partnership is limited to offering a section 6664 defense based on reasonable cause and good faith of the TMP or the partnership as an entity. The determination at the partnership-level as to the threshold applicability of the penalty is conclusive in a subsequent partner refund action.

B. The Problem with Penalties and Partnership-Level Proceedings

Recently, the Supreme Court clarified that accuracy-related penalties can be provisionally applied in a partnership-level proceeding based on adjustments to partnership items, even when partner-level “affected item proceedings” may be necessary to determine whether any partner has a deficiency upon which the penalty could be imposed. This leads to a unique procedural issue with TEFRA related penalties: section 6230(a) does not provide partner-level deficiency procedures for penalties that relate to adjustments to partnership items, yet affected items are subject to deficiency procedures if partner-level determinations are required.

As a result, the Service may not follow deficiency procedures for the imposition of penalties, but is required to follow deficiency procedures to assess the underpayment (an affected item) to which the penalty applies, except when the adjustment is strictly computational.

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80 P.L. 107-34, enacting I.R.C. §§ 6221; 6226(f); 6230(c)(4).

81 I.R.C. §§ 6621, 6626(f).

82 I.R.C. § 6664(c).


84 I.R.C. § 6230(c)(3).

85 Woods v. United States, 134 S. Ct. 557 (2013). In Woods, the district court determined that the partnership lacked economic substance, thus the partners could not have an outside basis in the partnership greater than zero. While outside basis is an affected item not to be determined in a partnership-level proceeding, the Supreme Court found that the court in a partnership-level proceeding was “not required to shut its eyes” to the impact of its partnership-level adjustment on an affected item such as outside basis. Id. at 565.
For example, the court in the partnership-level proceeding may make adjustments to partnership items and provisionally apply a penalty that depends on partner-level items, such as a partner overstating his “outside basis” in his partnership interest. Once the partnership-level proceeding is complete, the Service will issue statutory notices of deficiency to the partners regarding affected items that require “partner level determinations,” including the outside basis in this example. The partners can challenge the notices of deficiency in Tax Court, but such review appears limited to the affected item (e.g., the determination of outside basis) and does not appear to extend to any penalty defense. Finally (and only after full payment of the penalties), the partner then can file a refund claim in order to raise partner-level defenses to the penalties that in this example are predicated on the overstated outside basis. This unique procedural issue can spawn three separate proceedings to address the tax consequences of one partnership transaction, which is clearly inefficient and burdensome. We discuss TEFRA litigation in more detail in Part VI, below.

C. Lack of Efficiency and Consistency

The current partnership procedures frustrate administrative efficiency and judicial consistency, the very goal that TEFRA originally sought to achieve. The multiple proceedings that often are required under the current system force taxpayers and the government to educate different courts about the same complex transactions, which costs additional time and money and clogs the already backlogged dockets of courts around the country. Moreover, the need for several different courts to make factual determinations in different proceedings can result in unnecessary (and avoidable) inconsistency.

D. The Direct and Indirect Costs of Multiple Proceedings

The need for multiple proceedings costs taxpayers and the government countless dollars in litigation fees, delaying resolution of the matter and adding to taxpayer uncertainty. The effect of protracted litigation can sometimes cause a decade-long delay in collection of revenue related to the underpayment of tax and penalties, leading to suboptimal tax administration and collection.

As stated previously, partnership-level proceedings clog the dockets of not only the Tax Court, but also district courts across the country. After an FPAA is issued following a partnership-level audit, partners may either challenge the adjustment in refund actions in district court or the Court of Federal Claims, or they may challenge the FPAA in Tax Court without the

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87 For example, in *NPR Investments, L.L.C. v. United States*, the District Court for the Eastern District of Texas determined that the adjustments to partnership items in the FPAA were valid. 732 F. Supp. 2d 676, 678 (E.D. Tex. 2010). The district court also determined that some penalties were inapplicable, because of the partners’ reasonable belief and good faith reliance on their advisors. Id. On appeal the Fifth Circuit held that the district court did not have jurisdiction to determine partner-level defenses. *NPR Investments, L.L.C. v. United States*, 740 F.3d 998, 1000 (5th Cir. 2014). The partners must again litigate their defenses to the penalties in a separate proceeding. Barring any further appeals, two trial courts and one appellate court will have had to educate themselves about TEFRA jurisdiction and the complex underlying transaction before this matter will be resolved.
need for a jurisdictional deposit. Once the partnership-level proceeding concludes, the partner must raise his or her defenses to the penalties in a refund action after full payment and filing of an administrative refund claim, either in the applicable district court or the Court of Federal Claims.

As a result, once the first round of partnership-level proceedings is completed, new partner-level proceedings must be docketed, which defeats the administrative efficiency that was originally sought by enacting TEFRA. That process may be efficient when the penalty is predicated on partnership-level reporting, as it will be quite rare in such cases for the partners to have separate partner-level defenses to offer, and, in fact, that seems to be the logic of the 1997 changes to TEFRA. Yet, that process is extremely inefficient when the penalty is predicated on partner-level conduct because those types of cases are far more likely to result in multiple proceedings.

E. Lack of Prepayment Forum

By allowing courts to provisionally apply penalties in partnership-level proceedings, partners are denied traditional deficiency proceedings with respect to their defenses to such penalties. If the penalties relate to an adjustment of a partnership item, section 6230 denies them deficiency proceedings. Thus, the Service can directly assess the penalty against the partner, forcing the partner to first pay the penalty and then pursue a refund action if he or she wishes to raise any defenses to the imposition of the penalty. The Tax Court noted in Tigers Eye that, while taxpayers do not have a constitutional right to a prepayment forum, many taxpayers and tax practitioners find lack of a prepayment forum fundamentally unfair. In effect, the current state of the law denies a partner the right to present partner-specific defenses to penalties related to adjustments to partnership-items unless he or she has the liquid assets to not only litigate the issue but also prepay the penalties. In sum, the status quo provides a forum to raise partner-level defenses only if the partner can afford to pay.

F. Conclusion

The applicability of penalties in certain TEFRA proceedings has created strange procedural outcomes when penalties are predicated on the conduct of one or a few partners. While provisionally applying penalties at the partnership-level may increase efficiency in partnerships of hundreds or even thousands of partners, most of the perceived gained efficiency is likely lost when the partnerships are much smaller or the offending conduct depends

88 The determination of the amount required to be placed on deposit may be unclear. In some cases where the partner with the least amount of liability at issue has made the deposit, the Service has required all partners in the partnership to make a deposit to proceed in the refund action. Additionally, the Service has in some cases taken the position that the partner must make a deposit for other years that are not currently being challenged in the refund action, but may be affected by the outcome of proceeding.

89 “The availability of the Tax Court as the prepayment forum to redetermine liabilities for Federal income taxes and associated penalties, although it originated in an act of legislative grace, has acquired—over the more than 70-year period since its inception—the status of a prescriptive right in the minds of tax practitioners and members of the public.” T.C. Memo. 2009-121, n. 28.
on partner-level factual determinations. Applying penalties at the partnership-level without allowing those partners to raise partner-specific defenses frustrates TEFRA’s initial purpose of efficiency and consistency. Instead, the courts should be free to consider specific partners defenses, when those defenses align with the factual determination at the partnership-level proceeding. Alternatively, all affected items including penalties related to adjustments to partnership-items should be determined at the partner-level.

VI. CLARIFICATION NEEDED TO ADDRESS JURISDICTION, PROCEDURAL, AND OTHER COMMON ISSUES IN TEFRA LITIGATION PROCEEDING

A. Overview

The practical difficulties associated with TEFRA are especially pronounced in litigation, but these difficulties are confined and remediable.

B. Guiding Principles in TEFRA Litigation

Where TEFRA partnership proceedings are not resolved administratively, the Service issues an FPAA to signal the formal conversion of the TEFRA proceeding from the administrative stage to the litigation stage. Specifically, the issuance of the FPAA compels the partners to commence an action in one of the following three forums: the United States Tax Court (“Tax Court”); the United States Court of Federal Claims; or the U.S. district court in which the partnership’s principal place of business is located on the date that the petition is filed.91

The TMP has 90 days from the date of the FPAA to file a petition in the appropriate court.92 If the TMP does not petition the appropriate court, then any notice partner or five-percent litigation group may petition the appropriate court in the 60 days following the TMP’s 90-day period (i.e., within 150 days from the date of the FPAA). In cases petitioning an FPAA, courts consistently have agreed that they have jurisdiction to decide partnership items only.93

90 For example, many recent “tax shelter” cases involved small partnerships in which one or only a few partners claimed an inflated outside basis. One recent example is United States v. Woods, supra note 84, where the Supreme Court held that the court in a partnership-level proceeding has jurisdiction to determine whether a penalty “provisionally” applied when the partnership was found to be a sham. Whether the penalty actually applies, however, requires additional proceedings after the partnership-proceeding. First, a partner-level proceeding is required to determine the partner’s outside basis upon which the penalty should apply. Then a second partner-level proceeding may be necessary to consider whether that partner acted reasonably and in good faith with respect to the overstatement of its outside basis.

91 I.R.C. § 6226(a), (e)(1). A partnership with a principal place of business located outside the United States is treated as being located in the District of Columbia.

92 I.R.C. § 6226(a).

93 I.R.C. §§ 6221, 6226(f); see also Tigers Eye Trading, LLC v. Comm’r, 138 T.C. 67, 95 (2012) (“Generally, in partnership-level proceedings we have jurisdiction under section 6226(f) to determine all partnership items of the partnership for the partnership taxable year to which the FPAA relates, and we are not limited to the partnership items adjusted in the FPAA. . . . We also have jurisdiction to determine the proper allocation of those partnership items among the partners and the applicability of any penalty, addition to tax, or additional amount that
Similarly, courts in partner-level proceedings have agreed that they do not have jurisdiction to decide matters involving partnership items unless and until the partnership items have been converted to nonpartnership items.\footnote{See I.R.C. § 6231(b); see also Woods, supra note 84 (deciding whether a U.S. district court had jurisdiction to determine the applicability of any penalty that could result from an adjustment to a partnership item, even if imposing the penalty would also require determination of affected or nonpartnership items such as outside basis).} Only after the adjustments to the partnership items are final may the Service undertake further proceedings at the partner level to make any resulting “computational adjustments” in the tax liability of an individual partner.\footnote{I.R.C. § 6231(a)(6).} The balance of this section explains more nuanced rules associated with TEFRA litigation, details difficulties those rules can create in practice, and offers practical solutions to mitigate against these shortcomings.

C. Jurisdictional Concerns

1. Overview

TEFRA creates a number of jurisdictional issues for courts. These issues include both duplicative and inefficient proceedings, in contrast to the stated goals of TEFRA, as well as differing rights from traditional non-TEFRA proceedings, such as the inability to request a jury trial. Other issues include confusion in the courts about jurisdiction over untimely issued FPAAs, which can be caused by a failure to properly identify the TMP, confusion about the period of limitations in which an FPAA or an assessment against a partner related to partnership or affected items can be made, and distinguishing between partnership, nonpartnership, and affected items. By way of background, the general prerequisites for a court to obtain jurisdiction over a TEFRA proceeding are: (1) a validly issued FPAA; (2) a timely filed petition or complaint by a partner with an interest in the proceeding; and (3) if the action is filed in the Court of Federal Claims or a U.S. district court, the deposit of an amount that is equal to the proposed adjustment of tax for the petitioning party.\footnote{I.R.C. § 6226(a), (d), (e).}

2. Potential Jurisdictional Issues in Refund Court Litigation

TEFRA litigation in the U.S. district courts and the Court of Federal Claims presents several jurisdictional issues. For example, there is disagreement within the Court of Federal Claims as to whether the amount of the jurisdictional deposit required by section 6226(e) is simply the additional liability to the partner for the year at issue, or the additional liability for all open years that results from accepting the adjustments in the FPAA.\footnote{Compare Kislev Partners LP v. United States, 84 Fed. Cl. 385 (2008) (petitioning partner had to pay tax liability that would result in future years from FPAA issued for year of petition) and Russian Recovery Fund Ltd. v. United States, 90 Fed. Cl. 698 (2009) (same) with Prestop Holdings LLC v. United States, 96 Fed. Cl. 244 (2010) (petitioning partner only had to pay tax liability for year of petition).} Clarification in section 6226(e) with respect to this issue would be helpful.

relates to an adjustment to a partnership item.” (citing section 6226(f) and Treas. Reg. section 301.6226(f)-1(a) (internal citations omitted)).
An additional area of concern is the inability of a taxpayer to request a jury trial in a TEFRA partnership-level proceeding when the petition has been filed in a U.S. district court. At least one court has held that because the jurisdictional deposit is not a payment of tax, and because the petition is brought pursuant to 28 U.S.C. section 1346(e), not 28 U.S.C. section 1346(a)(1), the statute allowing a jury trial for actions to recover a refund of taxes paid under 28 U.S.C. § 1346(a)(1) does not apply. The impact of this decision is that taxpayers are denied the right to a jury trial in a TEFRA proceeding where it would otherwise be allowed in analogous non-TEFRA proceedings. 98 TEFRA and its legislative history are silent as to whether Congress intended to allow jury trials in a TEFRA proceeding. We suggest that Congress consider amending TEFRA to expressly allow jury trials for partnership-level proceedings.

Another problem involves the identification of the proper TMP. This issue often arises in the context of tiered partnerships, but is not limited to such partnerships. Because of the length of time that can pass before the audit of a TEFRA partnership is completed and an FPAA issued, partnership interests have often changed hands several times, and the originally designated TMP (if any) may no longer be available. These factors can contribute to the Service inadvertently issuing the FPAA to someone other than the TMP or failing to properly notify the notice partners, and a subsequent failure by the TMP to provide the FPAA and proper notice to the non-notice partners. 99 We suggest that TEFRA be amended or Treasury Regulations issued to clarify who is the TMP in such situations.

Finally, problems arise in the context of multiple petitions filed in response to an FPAA. Section 6226 establishes an order for determining which case will go forward when multiple petitions have been filed. The first priority is afforded to a petition filed by the TMP during the initial 90-day period after the FPAA has been mailed to the TMP. 100 If the TMP does not file a petition within this 90-day period, the next priority goes to the first Tax Court case filed by a notice partner or a five-percent litigation group. 101 If no Tax Court petition is filed, then priority is given to the first petition filed in the Court of Federal Claims or the U.S. district court for the district where the partnership’s principal place of business is located. 102

This priority scheme seems straightforward, but related questions concerning the identity of the TMP and the exclusion of partners named as debtors in a bankruptcy proceeding from the partnership-level proceeding 103 results in confusion where multiple petitions are filed by potentially ineligible partners. 104 The confusion surrounding the rules concerning the priority of

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98 28 U.S.C. § 2402 allows actions against the United States under section 1346(a)(1) to be tried with a jury at the request of either party.

99 I.R.C. § 6223(g).

100 I.R.C. § 6226(a), (b)(1); see also Transpac Drilling Ventures 1982-22 v. Comm’r, 87 T.C. 874 (1986).


102 I.R.C. § 6226(b)(3).

103 Treas. Reg. § 301.6231(c)-7(a) (converting partnership items to nonpartnership items as of the date of any bankruptcy petition is filed naming the partner as debtor).

104 See, e.g., Computer Programs Lambda, Ltd. v. Comm’r, 89 T.C. 198 (1987) (finding that a debtor in bankruptcy cannot commence or participate in a partnership proceeding, and that a petition filed by the president of the TMP in his individual capacity was invalid and did not commence a partnership action); Gran Esperanza P’ship
multiple petitions may discourage partners from filing additional protective petitions in cases that may have jurisdictional defects. A petition that is determined to be judicially deficient is subject to dismissal. If no other petition was filed, as a result of this confusion or otherwise, the partnership may be deemed to have failed to timely file a petition in response to the FPAA. The tax bar, as well as the courts, would benefit from guidance clarifying TEFRA’s treatment of the filing of multiple petitions.

D. Clarification Needed for Meaning of Key Terms: Partnership Items, Nonpartnership Items, and Affected Items

A large number of litigated TEFRA cases have centered on whether a given item is a partnership item, a nonpartnership item, or an affected item. The lack of clarity surrounding the classification of items causes unnecessary litigation. We believe that clarification of the statutorily defined terms (partnership items, nonpartnership items, and affected items) would significantly reduce the number of TEFRA cases being litigated.

E. Need Clarification on Reconciliation of the Treatment of Outside Basis

A partner’s basis in a partnership interest (or “outside basis”), is relevant in determining the ultimate income tax treatment of the partnership’s operations. For example, outside basis and application of the “at risk” rules under section 465 (among other provisions) will determine the tax consequence of income and loss allocated to each individual partner. Outside basis is also relevant in determining the tax treatment of partner-level transactions such as the sale or exchange of a partnership interest.

Because the determination of outside basis is based on events occurring at both the partnership and the individual partner level, that determination often exists in a gray area that, while technically an “affected item” within the meaning of section 6231(a)(5), is often closely related to, if not determined entirely by, events occurring at the partnership level (i.e., “partnership items” within the meaning of section 6231(a)(3)). This overlap can be particularly problematic in the context of TEFRA litigation because it can lead to jurisdictional uncertainty as to whether something is a partnership item or an affected item. When a taxpayer mistakenly assumes an item to be an “affected item,” and therefore does not litigate that item in a partnership-level proceeding, the item cannot be raised in a later affected item deficiency proceeding or refund action.

Notwithstanding the jurisdictional importance of outside basis, whether and in what circumstances it might be considered in connection with a TEFRA proceeding and, in turn, whether a court has jurisdiction to adjudicate it or make findings of fact in a TEFRA proceeding, v. Comm’r, T.C. Memo 1989-113 (where the Service identified two individuals as TMP of a partnership for the same tax year and issued an FPAA to each, and each purported TMP filed a petition, the court provided both individuals the opportunity to seek a determination that they were in fact the TMP for the tax year).

105 Courts have been willing to permit ratification of the judicially deficient petition in cases such as this. See, e.g., Starlight Mine v. Comm’r, T.C. Memo 1991-59 (partnership given 60 additional days to designate a new TMP to ratify the original petition); AMRB Assocs. v. Comm’r, T.C. Memo 1991-450 (same).
has been litigated extensively. Most recently, the Supreme Court in Woods\textsuperscript{106} considered whether a court in a partnership-level TEFRA proceeding had jurisdiction to determine the applicability of accuracy-related penalties under section 6662 when a determination had been made that the partnership itself was a sham for tax purposes. The sham partnership determination necessarily carries with it a determination that each partner has overstated the partner’s outside basis by 100 percent (i.e., because there is no partnership, there can be no outside basis). The Service has long argued that the overstatement of outside basis in this context gives rise to a gross valuation misstatement penalty under section 6662(b)(3) and (h) that must be adjudicated in a partnership-level proceeding, a position separately confirmed by the Supreme Court’s decision in Woods. Prior to Woods, the Tax Court, the D.C. Circuit, and the Federal Circuit struggled with the issue, reaching divergent conclusions.\textsuperscript{107}

While outside basis is generally an affected item, citing the “relates to” language unique to penalties in section 6226(f), the Supreme Court held in Woods that, in the context of a sham partnership, outside basis is closely related enough to a partnership item for a court in a partnership proceeding to consider it when answering the threshold question of whether penalties apply (but not, however, whether penalties will ultimately be imposed):

We hold that TEFRA gives courts in partnership-level proceedings jurisdiction to determine the applicability of any penalty that could result from an adjustment to a partnership item, even if imposing the penalty would also require determining affected or non-partnership items such as outside basis. The partnership-level applicability determination, we stress, is provisional: the court may decide only whether adjustments properly made at the partnership level have the potential to trigger the penalty. Each partner remains free to raise, in subsequent, partner-level proceedings, any reasons why the penalty may not be imposed on him specifically.\textsuperscript{108}

Relying on the unique language in section 6226(f) added by TRA 97,\textsuperscript{109} the Supreme Court in Woods reached the right logical result, albeit one that may not be easily reconciled with the definitions of “partnership item” and “affected item” in section 6231 and the regulations thereunder.\textsuperscript{110}

Although the Supreme Court resolved the “affected item” versus “partnership item” dispute in the context of penalties, similar issues can arise in other cases outside the scope of section 6226(f), where fact finding in a partnership proceeding is inextricably intertwined with the determination of outside basis. For example, application of the passive activity rules under

\textsuperscript{106} 134 S. Ct. 557 (2013).
\textsuperscript{108} Woods, 134 S. Ct. at 564.
\textsuperscript{110} Treas. Reg. §§ 301.6231(a)(3)-1, (a)(5)-1.
section 469 to losses flowing from a partnership will generally be a partner-level affected item. If, however, the partnership was determined to be a sham, or if a partner’s assertions regarding involvement in the partnership’s activities were determined to be illusory, adjudication of those facts might be subsumed within fact-finding conducted in a partnership-level proceeding, even if the ultimate determination under section 469 takes place at the individual partner or affected item level. Similarly, a determination of basis in assets contributed to a partnership by a partner may impact both partnership items (e.g., the partnership’s depreciation deduction) and affected items (e.g., outside basis for purposes of calculating gain on loss on disposition of a partnership interest). As another example, a partnership’s liability (a partnership item) is generally allocated to individual partners under section 752, thereby increasing each partner’s outside basis.

In each of these scenarios, a court in a partnership-level TEFRA proceeding may make findings of fact that will, for all practical purposes, resolve the later determination of an affected item, even though the court does not have subject matter jurisdiction to make an ultimate finding or determination regarding the affected item. This leads to jurisdictional confusion over what is and what is not a partnership item, as well as duplicative and unnecessary administrative proceedings, affected item litigation, and delay.

To resolve this issue, provide greater jurisdictional certainty, and streamline resolution of partnership tax disputes, we suggest that section 6231 be amended to allow courts in partnership-level proceedings to exercise supplemental jurisdiction to make ultimate findings or determinations regarding affected items. That jurisdiction would be exercised only in situations where resolution of the affected item is heavily, if not entirely, dependent on fact-finding that is already being conducted in the partnership-level proceeding. The procedures set forth in 28 U.S.C. section 1367, which gives federal courts “supplemental jurisdiction” over state law and other claims once original subject matter jurisdiction has been established, provide an analogy. We believe supplemental jurisdiction, while possibly raising disputes regarding its proper use, will reduce time spent in litigation by allowing courts to resolve as many issues as appropriate in one partnership-level case rather than multiple partner-level cases. Such streamlined resolution of partnership issues is consistent with the goals of TEFRA.

F. Coordination is Needed Between Deficiency and Refund Actions

1. Overview

The TEFRA litigation procedures in section 6226 were designed, in part, to track the traditional deficiency and refund procedures of sections 6211 through 6216, and 6511 through 6515. Yet there are critical—and often jurisdictional—differences that can create traps for the unwary, add unnecessary complexity to partnership proceedings conducted in refund forums, and, in some cases, leave taxpayers without judicial recourse. This cuts against equitable tax administration. In addition to our recommendations in section III above, we offer the following recommendations regarding venue, and the jurisdictional deposit.

2. Venue

A TMP, notice partner, or five-percent group can challenge an FPAA by timely filing an action in the Tax Court, the Court of Federal Claims, or “the district court of the United States
for the district in which the partnership’s principal place of business is located.”  

Section 6230(j) provides that a partnership’s principal place of business located outside the United States shall be treated as located in the District of Columbia. For a dissolved partnership with no principal place of business at the time an FPAA is issued, an FPAA can be challenged only in the Tax Court or the Court of Federal Claims.

Given the delay that is often inherent in TEFRA audits, it is common for a partnership to have dissolved by the time an FPAA is issued. In other cases, it may not be obvious where a partnership’s principal place of business is at the time an action challenging an FPAA determination is filed. In regular refund actions, district court venue is preserved and these uncertainties are mitigated by 28 U.S.C. § 1402, which allows a refund action to be brought in the district court for the district where the taxpayer’s return for the year at issue was filed. We recommend that a similar venue provision under TEFRA, allowing filing in the district where the partnership return was filed, would better align partnership cases with regular refund actions.

3. Jurisdictional Deposit

To challenge an FPAA in district court or the Court of Federal Claims, the TMP, petitioning notice partner, or five-percent group must, on or before the date the petition is filed, make a jurisdictional deposit equal to “the amount by which the tax liability of the partner would be increased if the treatment of partnership items on the partner’s return were made consistent with the treatment of partnership items on the partnership return, as adjusted by the [FPAA].” The jurisdictional deposit requirement has been a source of uncertainty and litigation, particularly in the context of tiered partnerships, where calculation of the hypothetical increase in tax involves looking through multiple layers of partnership interests. Calculating the deposit can be further complicated by facts unique to the petitioning partner (i.e., affected items). In contrast, applying the “full payment” rule in regular refund actions is usually more straightforward—the taxpayer need only pay the amount that the Service has calculated to be due and owing. We recommend that some of the complexity surrounding computation of the jurisdictional deposit would be eliminated if the TMP, petitioning notice partner, or five-percent group was allowed to calculate the deposit based on application of a fixed tax rate (e.g., 25%) to the adjustments set forth in the FPAA, without flowing those adjustments through to an ultimate partner’s actual return.

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111 I.R.C. § 6226(a).
112 See, e.g., Transcapital Leasing Assocs., L.P. v. United States, 398 F.3d 1317 (Fed. Cir. 2005) (finding section 6226(a) to be a venue provision, rather than a jurisdictional provision, allowing a petition filed in district court to be transferred to the Court of Federal Claims).
113 I.R.C. § 6226(e).

1. Overview

TEFRA’s purpose is to streamline partnership audits by allowing the Service to centralize administration and settlement principally with the TMP. This streamlined process causes partners, and especially non-notice partners, to forfeit much control over the resolution and strategy for resolving their alleged tax liabilities. The Code offers these partners numerous opportunities to elect-out of a TEFRA proceeding, but these provisions are overly simplistic in that they fail to account for many of the circumstances under which a partner may desire to elect out of a TEFRA proceeding.

2. Proposal to Broaden the Ability to Elect-Out of TEFRA in Connection With a Request for Prompt Assessment under Section 6501(d)

Normally, the period of limitations on assessment is limited to three years. An estate and certain liquidating corporations may request a prompt assessment that generally shortens the period of limitations on assessment from 3 years to 18 months from the date of the request. The prompt assessment provisions of section 6501(d) are intended to provide electing estates and certain liquidating corporations finality in connection with (1) computing the entity’s tax liabilities, and (2) ensuring that a transferor of an estate’s or a dissolved corporation’s property does not distribute property when tax debts of the entity are owing. The ability for any taxpayer to seek a prompt assessment would be welcomed, and there may well be competing considerations with respect to how broadly this option should be made available. In the context of a decedent and a decedent’s estate, the ability to seek prompt assessment is particularly important for an executor who needs to be able to distribute the assets of the estate and settle the estate, but could risk personal fiduciary liability or place the beneficiaries at risk of transferee liability if tax issues remain unresolved. However, TEFRA disturbs the finality that the prompt assessment provisions that section 6501(d) is intended to provide. To effectively provide the relief granted in section 6501(d), certain changes would be required.

Treasury Regulations acknowledge that the treatment of partnership items with respect to a partner on whose behalf a request for prompt assessment of tax under section 6501(d) is filed may interfere with the effective and efficient enforcement of the internal revenue laws. As a result, Treasury Regulations treat partnership items that are subject to a request for prompt assessment under section 6501(d) as nonpartnership items as of the date the request is filed.

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115 I.R.C. § 6501(a).
116 I.R.C. § 6501(d). The request for prompt assessment is typically made by filing with the Service a Form 4810, Request for Prompt Assessment Under Internal Revenue Code Section 6501(d).
117 The transferor may be personally liable to the Treasury for any distributions made when federal taxes are still due and owing. See I.R.C. §§ 3713(b) (creating an underlying liability for a personal representative), 6901(a)(1)(B) (authorizing the Service to use their standard assessment and collection methods for that liability).
118 Treas. Reg. § 301.6231(c)-8.
119 Id.
This relief is welcomed, but section 6501(d) is limited in application. Section 6501(d) cannot apply with respect to a return for which the taxpayer and the Service agree in writing to extend the period of limitations on assessment. Nor can section 6501(d) apply if the partnership omits from gross income an amount properly included therein and such amount is (i) in excess of 25% of the amount of gross income stated in the return, or (ii) is attributable to one or more foreign financial assets within the meaning of section 6038D. These exceptions, which render section 6501(d) inapplicable, are routinely present in TEFRA partnership proceedings. In this regard, as applied to TEFRA partnership audits, the exceptions to section 6501(d) swallow the general rule.

We suggest that the tension between TEFRA and section 6501(d) be relieved by adopting a provision that allows a partner on whose behalf a request for prompt assessment of tax under section 6501(d) is filed to elect out of TEFRA without regard to the general restrictions set forth in sections 6501(c), (e), or (f). Such an amendment may reduce unnecessary litigation and foster the finality envisioned by section 6501(d).

3. Proposal to Broaden the Ability of Debtors to Elect-Out of TEFRA in Connection With Bankruptcy Proceedings

TEFRA prevents debtors from converting partnership items to nonpartnership items until a bankruptcy petition is filed. This undercuts certain objectives of the Bankruptcy Code. There are two important limitations to the “fresh start” provided by a bankruptcy proceeding. First, for the tax to be dischargeable, the tax must relate to a return due at least three years before the filing of the bankruptcy petition and also have been assessed more than 240 days before filing the petition. Second, the Bankruptcy Code defines as nondischargeable taxes that are not yet assessed, but are assessable by applicable law or agreement, such as due to an agreed extension of the period of limitations for assessments.

Partnership items subject to TEFRA are assessable, but not assessed, until at least the later of (1) 150 days after the FPAA is issued or, (2) if a proceeding in Tax Court is commenced, after the Tax Court’s decision has become final. Treasury Regulations acknowledge that the treatment of items as partnership items in respect of a partner named as a debtor in a bankruptcy proceeding may interfere with the effective and efficient enforcement of the internal revenue laws. Accordingly, when a partner files for bankruptcy, the partner’s partnership items in

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120 I.R.C. § 6501(c)(4), (d).
121 I.R.C. § 6501(d), (e)(1).
122 The primary goal of the Bankruptcy Code is “to relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.” Williams v. U.S. Fidelity & Guaranty Co., 236 U.S. 549, 554-55 (1915).
123 11 U.S.C. §§ 523(a)(1); 507(a)(8).
125 I.R.C. § 6225(a).
126 Treas. Reg. § 301.6231(c)-7.
TEFRA partnerships convert to non-partnership items if the Service could file a claim for income tax in the bankruptcy proceeding.\textsuperscript{127} This treatment is intended to allow all tax claims to be resolved in the bankruptcy proceeding, but as a practical matter is unsatisfactory because it is sometimes more efficient to resolve the tax claims before bankruptcy is filed. A debtor who seeks to have partnership items discharged in bankruptcy must either (1) delay filing a bankruptcy petition until the Tax Court’s decision becomes final, the Service assesses the tax, and an additional 240 days run, or (2) immediately file a bankruptcy petition, omit the partnership items from the list of dischargeable liabilities, and resolve the partnership items that have converted to non-partnership items as part of the bankruptcy proceeding. Both alternatives are unsatisfactory; the first alternative may lead to delay plus unnecessary litigation to resolve the partnership items, whereas the second alternative unnecessarily delays the bankruptcy process while the converted partnership items are resolved.

We suggest that the tension between TEFRA and the Bankruptcy Code be relieved by adopting provisions that allow a debtor to affirmatively elect to treat partnership items as nonpartnership items at any time when it is insolvent without tying that election to the filing of a bankruptcy petition. Such an amendment would likely reduce unnecessary litigation and further the Bankruptcy Code’s purposes.

4. Proposal for an Elect-Out Provision in Connection With Collection Due Process Cases

We suggest that TEFRA be amended to account for the fact that the treatment of partnership items with respect to a partner who has sought a collection alternative, such as an offer in compromise or an installment agreement, may interfere with the Service’s effective and efficient collection of tax. Although no such provision presently exists, we suggest that it be added to any proposed reform of the TEFRA provisions.

By way of background, the Service is authorized to (i) compromise any civil or criminal case involving a taxpayer’s federal tax liabilities (known as an offer in compromise),\textsuperscript{128} and (ii) enter into written agreements which allows taxpayers to pay tax in installment payments if the Secretary determines that such agreement will facilitate the efficient collection of tax (known as an installment agreement).\textsuperscript{129} Two conditions are relevant to the effect that TEFRA may have on offers in compromise and installment agreements. First, an offer in compromise or installment agreement must cover all of the taxpayer’s then-existing liabilities.\textsuperscript{130} Second, an offer in compromise requires that the taxpayer not accrue additional or new liabilities after entering into an installment agreement. In practice, the failure to comply with either condition generally causes the collection alternative to be rejected and the taxpayer’s assets subject to levy.

\textsuperscript{127} \textit{Id.}

\textsuperscript{128} \textit{See} I.R.C. § 7122.

\textsuperscript{129} \textit{See} I.R.C. § 6159(c).

\textsuperscript{130} \textit{See}, e.g., IRM § 4.20.4.2 (installment agreements) and 8.23.3.4 (instructing Service employees to add to an offer in compromise any other outstanding liabilities of the taxpayer).
As a result of the extended period of time that it may take for the Service to assess a TEFRA liability by virtue of section 6229(b)(1), the Service and the taxpayer may be unable to include the taxpayer’s TEFRA liabilities in the collection alternative because those liabilities may not be known until after the collection alternative is entered into. In this regard, the treatment of partnership items of a partner who was granted an offer in compromise or an installment agreement may lead to a default on the collection alternative agreement and subject the taxpayer to immediate levy. Thus, TEFRA may frustrate the Service’s effective and efficient collection of tax under sections 6159 and 7122.

The problem created by post-collection alternative TEFRA liabilities could be addressed by amending section 6231(c)(1) to automatically treat post-collection activity TEFRA liabilities as nonpartnership items subject to inclusion in the collection alternative. This result furthers the Service’s interest in the effective and efficient collection of tax and taxpayers’ interest in achieving finality through a collection alternative.

VII. CLARIFICATION NEEDED TO ADDRESS THE DIFFICULTIES OF APPLYING TEFRA TO TIERED PARTNERSHIPS

A. Overview

Despite the U.S. Treasury recognizing as early as 1978 the unique problems presented by tiered partnerships, TEFRA does nothing to solve those problems. In fact, TEFRA is especially difficult to apply in the context of tiered partnerships (i.e., where a partnership or other pass-through or disregarded entity is a partner in the TEFRA partnership facing litigation). The problems that tiered partnerships present are growing increasingly prevalent, as described previously. Guidance would be helpful to identify the TMP of a tiered partnership structure, and to determine how the bankruptcy of a pass-through partner affects the TEFRA proceedings.

B. Difficulties in Identifying the TMP in Tiered Partnership Structures

Many upper-tier partnerships in tiered partnership structures were formed before TEFRA was enacted, and the upper tier partnerships’ governing agreements often do not designate a TMP. The Code and Treasury Regulations provide a set of rules for determining who is authorized to bind the upper-tier partnership in a TEFRA proceeding. However, the Service often does not follow these procedures during the administrative TEFRA proceeding, which
leads to confusion and unnecessary pretrial motions. For example, the difficulties created by the lack of clarity as to who is the TMP in a tiered partnership structure is exemplified by a pair of consolidated TEFRA cases presently docketed before the Tax Court: Annabelle Ltd. P’ship v. Commissioner, No. 17523-13 (T.C. filed July 30, 2013), and Broadway 21st Associates v. Commissioner, No. 17641-13 (T.C. filed July 30, 2013). These cases involve multiple disputes regarding who is entitled to act on behalf of the partnership, including assertions that the statute of limitations has expired because the wrong party executed the statute extensions and assertions that the petition should be dismissed because the wrong party filed the petition.

C. Bankruptcy of the Pass-Through Partner

The bankruptcy of a partner will normally cause the partner’s partnership items to be converted into nonpartnership items.134 If the bankrupt partner is a pass-through partner, however, the Service takes the position that the bankruptcy does not convert the partnership items of indirect partners, who own interests in the pass-through partner, into nonpartnership items.135 The Service’s position poses a serious threat to an indirect partner’s right to control the resolution of its own tax liability. After filing for bankruptcy, the pass-through partner will be cut-off from the TEFRA proceedings and will no longer receive any notices to forward to the indirect partners. Unless the indirect partners are notice partners or have been identified to the TMP, the TEFRA rules provide no means for the indirect partners to receive notice of the partnership-level proceedings. We suggest that the TEFRA’s rules be amended to continue to provide notice to an indirect partner who owns its interest through a pass-through partner that files for bankruptcy and has its partnership items converted to nonpartnership items.

CONCLUSION

We commend Congress for its ongoing efforts to reform the partnership administrative procedures. This area of the law is unnecessarily complicated and has resulted in administrative problems for both taxpayers and the government. While Congress had good intentions in 1982 in enacting the TEFRA partnership procedures, the realities of how partnerships are structured require certain amendments to TEFRA.

The American Bar Association Section of Taxation recognizes the desire for reform and appreciates that simplification must be balanced against the need for the continued flexibility that the partnership as an entity structure allows—and governing tax law permits—in its many forms, including tiered partnership structures and foreign partnerships. We recommend that reforms to the partnership administrative regime not eliminate benefits allowed to taxpayers who chose to operate businesses and investment activities through partnership forms.

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